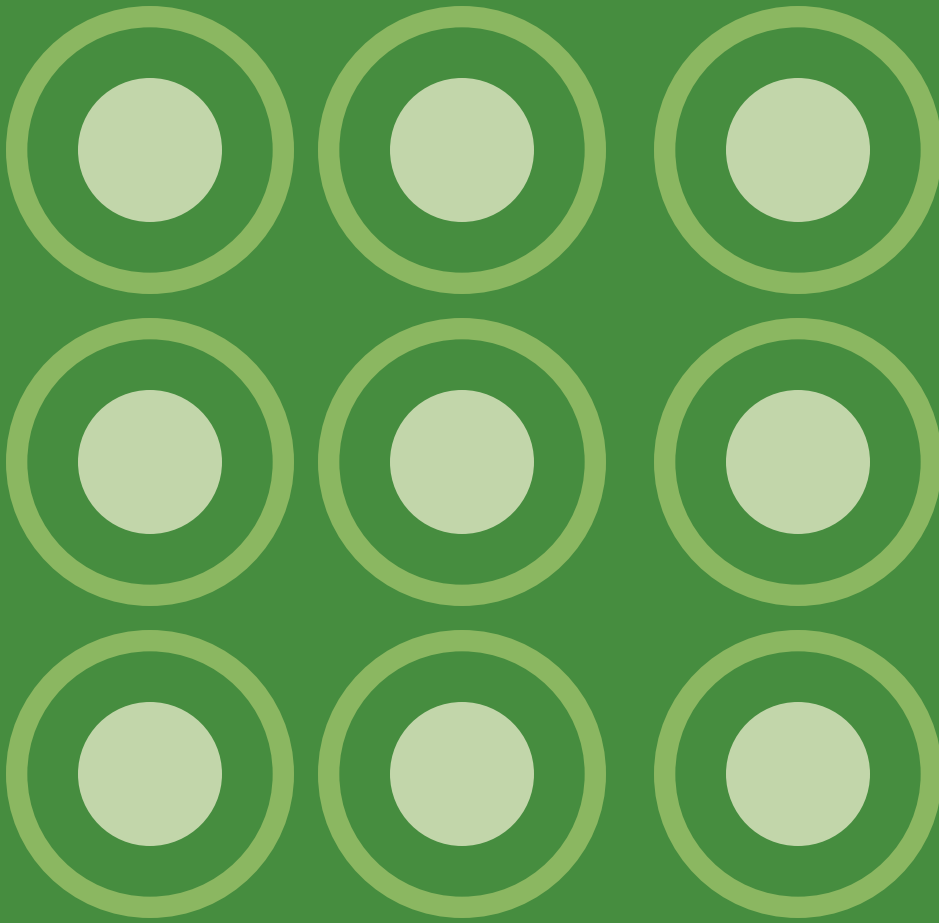


Case Closed: eNotes Are Legal

An Analysis of eNote Enforceability Nationwide



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Understanding How eNotes are Legal in All Jurisdictions

Lenders are always looking for ways to cut costs, improve compliance and create efficiencies. One way of achieving these goals is to create a paperless mortgage lending environment. There is still some confusion, however, in the industry as to whether electronically-signed promissory notes (commonly referred to as “eNotes”) are legal in every jurisdiction. This paper will explain that under the federal Electronic Signatures in Global and National Commerce Act (“ESIGN”)¹ and the Uniform Electronic Transaction Act (“UETA”)², eNotes can be originated, validated and enforced on a nationwide basis.

The “Original” Problem

Accommodating the law of negotiability for promissory notes was one of the most significant challenges faced by the drafters of UETA and ESIGN. By definition, an electronic record cannot be physically transferred via telecommunication; any transmission of the electronic record (without sufficient means or assurance that the record transferred is unique) results in the creation of a duplicate record at the receiving end, not the physical transfer of an “original” or initial record, with no certainty that the “original” has been destroyed or otherwise marked as a copy. For these reasons, the assumptions underlying existing rules for negotiability do not work in an electronic environment.

The Electronic Solution

As a result and in order to create legal parity for electronic transactions with negotiable promissory notes, UETA and ESIGN set forth special rules for the management and retention of eNotes.

UETA and ESIGN provide for treating an electronic record as the equivalent of a negotiable promissory note in certain respects if:

- The electronic record contains only the same terms and conditions that are permitted in a promissory note governed by Article 3 of the UCC³;

¹ 15 U.S.C. 7001 *et seq.*; Pub. Law 106-229 (June 30, 2000).

² The UETA was adopted by the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) in 1999. NCCUSL is the same 116-year old body of jurists and legal practitioners that promulgated the Uniform Commercial Code (“UCC”) and myriad other model laws that form the backbone of much of state law. ESIGN is based in significant part on UETA.

³ Article 3-104 of the Uniform Commercial Code defines a “negotiable instrument” to mean an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:

- (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;
- (2) is payable on demand or at a definite time; and

- The electronic record is signed;
- The issuer of the record has agreed that it should be treated as a transferable record under the UETA; and
- The method used to record, register, or evidence a transfer of interests in the transferable record reliably establishes the identity of the person entitled to “control” (meaning control the transfer of) the electronic record.

If these conditions are met, the record (or the eNote) under UETA and ESIGN is called a “transferable record” and a person identified as in “control”⁴ of the transferable record becomes the equivalent of a “holder” under the Uniform Commercial Code (“UCC”). In essence, this structure provides an explicit statutory alternative to the three physical attributes of a negotiation: delivery, indorsement and possession.

UETA and ESIGN’s approach is noteworthy in that neither statute attempts to insert the concept of a transferable record *into* the UCC. Instead, UETA and ESIGN exclude from their scope most of the UCC, and instead *pull out* of the UCC those concepts that are still valuable in an electronic environment and create an equivalent legal framework, and at the same time leave the balance of the rules applicable to a transferable record to agreement, system rule or other law.

Which State Laws Support eNotes?

The following 47 jurisdictions have adopted the version of UETA approved by NCCUSL, or some modified version of it: Alabama, Alaska, Arizona, Arkansas, California,⁵ Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia, Wisconsin and Wyoming.⁶

With the notable exception of California, all of these jurisdictions have adopted the transferable record provisions of UETA (Section 16), thus enabling the use of eNotes. The

(3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.

⁴ ESIGN and UETA provide “safe harbor” standards for establishing the integrity of the record and the identity of the person in control of the transferable record. The standards are quite strict. *See* ESIGN Title II (b); UETA § 16.

⁵ California, however, does not include UETA’s Section 16 provision. See discussion below.

⁶ *See* <<http://www.nccusl.org/>>.

remaining four states (Georgia,⁷ Illinois,⁸ New York⁹ and Washington¹⁰) have adopted an electronic signature law other than UETA that purports to govern the general use of electronic records and signatures to some extent. As will be discussed in more detail below, notwithstanding these state variations from UETA (including the absence of Section 16) and ESIGN, eNotes associated with residential mortgage loans originated in California, Georgia, Illinois, New York and Washington are validated and supported by the transferable records provisions in Title II of ESIGN.

What if My State Law Does Not Expressly Support eNotes?

eNotes will be enforceable under ESIGN, notwithstanding state law. First, ESIGN permits a state law to modify, limit or supersede the provisions of 101 of ESIGN so long as the state law constitutes an enactment of the NCCUSL-sanctioned version of UETA, or, if it is a state law alternative, such alternative must be consistent with ESIGN (both Title I, which delineates the electronic records and signatures in commerce provisions, and Title II, which sets forth transferable records provisions).

To the extent that any of the non-UETA electronic signature laws mentioned above, or any version of UETA that is not NCCUSL-sanctioned (such as California's) contain significant limitations not found in ESIGN or in UETA, such limitations would likely be found to be not consistent with ESIGN, and thus preempted.¹¹

⁷ While stating that it is consistent with ESIGN, the Georgia Electronic Records and Signatures Act excludes the law's application to "any record that serves as a unique and transferable token of rights and obligations, including, without limitation, negotiable instruments . . ." O.C.G.A. § 10-12-4(i)(3).

⁸ The Illinois Electronic Commerce Security Act provides as follows:

The provisions of this Section do not apply to any record that serves as a unique and transferable instrument of rights and obligations including, without limitation, negotiable instruments and other instruments of title wherein possession of the instrument is deemed to confer title, unless an electronic version of such record is created, stored, and transferred in a manner that allows for the existence of only one unique, identifiable, and unalterable original with the functional attributes of an equivalent physical instrument, that can be possessed by only one person, and which cannot be copied except in a form that is readily identifiable as a copy.

5 ILCS 175/5-115 (b)(3)

⁹ The New York Electronic Signatures and Records Act § 307 provides that: This article shall not apply: . . . [t]o any negotiable instruments and other instruments of title wherein possession of the instrument is deemed to confer title, unless an electronic version of such record is created, stored or transferred pursuant to this article in a manner that allows for the existence of only one unique, identifiable and unalterable version which cannot be copied except in a form that is readily identifiable as a copy.

¹⁰ The Washington Electronic Authentication Act provides that "[no] digital message shall be deemed to be an instrument under Title 62A RCW (the state UCC provisions including the provisions for negotiable instruments) unless all parties to the transaction agree, including financial institutions affected.

¹¹ At this point, there are no judicial decisions interpreting the ESIGN preemption provisions or the "consistency" test. Therefore, any analysis of the scope of preemption must be based solely on a reading of the statute.

In addition, as indicated above, ESIGN expressly permits states to supersede provision 101, but not Title II which addresses transferable records secured by real property. Title II of ESIGN will always be applicable to a real estate-secured transaction regardless of a state UETA adoption or an alternative that is consistent with ESIGN.¹² Therefore, lenders that intend to originate real estate-secured eNotes will always be able to rely on ESIGN to provide the basis for validating and legally enforcing such transactions.

How Do I Implement eNotes?

A growing number of mortgage lenders are using eNotes today.¹³ The Mortgage Industry Standards Maintenance Organization (MISMO) has a number of published guides to educate lenders on how to get started with eNote implementation.¹⁴ Additionally, lenders should also review the various eMortgage guides published by investors who are accepting eNotes.¹⁵ Lenders should also become familiar with the MERS® eRegistry owned and operated by MERSCORP, Inc., which is an industry utility that was created with extensive input from leadership in all sectors of the real estate finance and related industries to track ownership interests in eNotes.¹⁶ Finally, for more information on legal and implementation issues related to electronic records and signatures in general, lenders should review the Standards and Procedures for electronic Records and Signatures (SPeRS) manual,¹⁷ which was also drafted over the course of several months with extensive involvement from a wide range of groups and companies within the financial services and high technology industries.

¹² The legislative history on ESIGN contains an explanatory statement of the law and addresses among other things, the desire to have uniform national standards for “transferable records”:

The conference report adopts a new provision in recognition of the need to establish a uniform national standard for the creation, recognition, and enforcement of electronic negotiable instruments. The development of a fully- electronic system of negotiable instruments such as promissory notes is one that will produce significant reductions in transaction costs. This provision, which is based in part on Section 16 of the Uniform Electronic Transactions Act, sets forth a criteria-based approach to the recognition of electronic negotiable instruments, referred to as 'transferable records' in this section and in UETA. It is intended that this approach create a legal framework within which companies can develop new technologies that fulfill all of the essential requirements of negotiability in an electronic environment, and in a manner that protects the interests of consumers.

See 146 Cong. Rec. S5281 (June 16, 2000).

¹³ For recent statistics on the use of eNotes, see the Mortgage Bankers Association website’s eMortgage Dashboard at <http://www.mortgagebankers.org/eMortgage>

¹⁴ The MISMO eMortgage Guide and eMortgage Closing Guide are valuable resources to assist a lender’s understanding of how to implement eMortgages. These guides and other valuable information are available at www.mismo.org.

¹⁵ For general information on Fannie Mae and Freddie Mac’s guidance on eMortgages, see their respective websites at www.efanniemae.com and www.freddiemac.com.

¹⁶ MERS publishes several implementation guides on the use of the MERS® eRegistry at www.mersinc.org.

¹⁷ SPeRS is available at www.spers.org.

Conclusion

UCC Article 3 provisions for promissory notes were not designed for use with electronic records. Rather, ESIGN and UETA were enacted to create the legal framework or a parallel structure for the electronic equivalent of a paper promissory note, known as a “transferable record.” As a result, an eNote that is created, stored and maintained as required under ESIGN and UETA is a valid, enforceable and negotiable debt obligation. To the extent that a state has not adopted UETA or a state law alternative that is consistent with ESIGN, Title II of ESIGN may be relied upon to validate the creation, storage and transfer of eNotes originated under any state law.